March 2018

Hodes Weill's Top 10 Observations (not facts) for 2018

FACT [fakt]: A thing that is indisputably the case; the truth about events as opposed to interpretation

Reading global real estate markets and making investment decisions did not get any easier since we presented our last annual market observations. 2017 was a year in which seemingly every morning's Twitter feed identified yet another Black Swan that could materially upend investment strategies, markets and entire governments. Seriously, how excited could we get about cap rates and capital flows when nuclear taunts were flying back and forth across the sea? Not only has the exceptional become the norm, the coverage of news itself has become exceptional. After all, 2017 was also the year in which we learned about the existence of "alternative facts." In a world that can accept alternative facts, the need for trusted sources is more important than ever. Against this backdrop, Hodes Weill will continue to strive to provide our views and observations in an unvarnished and balanced fashion.

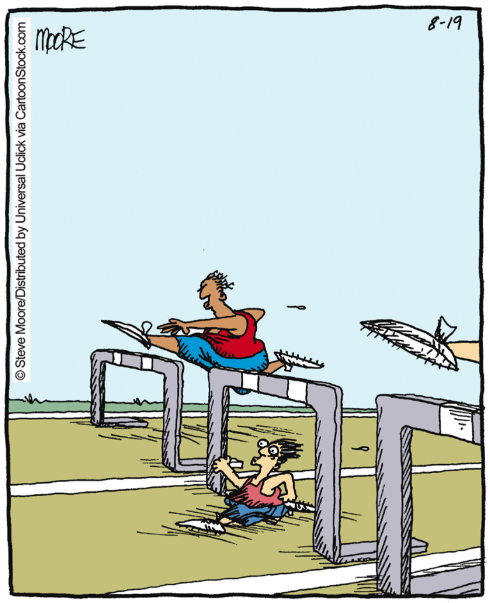
Stepping back from the drama in the world of politics and global diplomacy, the past year was a fairly predictable and consistent one in the world of private equity real estate. Most investors maintained their strategic focus on real estate, increasing exposure where appropriate and taking chips off the table selectively. At this point in the cycle, we are witnessing behavior that we believe demonstrates the appropriate level of prudence given the overall (if uneven) state of recovery in global real estate markets. Caution continues to be the order of the day, despite some larger, newer entrants to the market that are aggressively building portfolios. It is a difficult task to nimbly grow portfolios at a time when market values are advancing well beyond the peaks reached before the financial crisis of 2008, now a full decade past. It is, therefore, not surprising that capital flows to private real estate (both direct and indirect) are down from prior peak years. In some respects, it is notable that in the 10th year of recovery, investors have not moved to the sidelines.

And so, amidst a complicated global geopolitical environment and a long-dated real estate market recovery, we are pleased to set out our annual Market Commentary. We hope these observations are helpful and very much look forward to hearing your feedback.

1. When It Comes To Real Estate Loans, Go Short (Duration)

Many investors believe the U.S. real estate market has reached a late stage in the cycle. As a result, investors have been shifting some of their real estate allocation to real estate debt investments as a way to position themselves more defensively. This capital rotation has become a key trend in the fundraising environment for private real estate funds; in 2017, private real estate debt funds raised a total of $28.9 billion, up from $22.1 billion in 2016 and $16.0 billion in 2015, while overall fundraising for real estate private equity was down 11.9%.[1] As a result, the share of debt funds raised as a percentage of the total has also grown, representing 24% of capital raised in 2017, up from 18% in 2016.[2]

The most obvious attractions of a real estate debt strategy at this point in the cycle are durable income and downside protection given the subordination of sponsor equity. However, managing duration also allows investors to risk adjust and have further defensive protections.



Loans on transitional real estate are commonly structured with an initial maturity of three years, with typical payoffs occurring within 18 to 24 months. Extensions beyond 3 years generally require that collateral meet certain performance criteria (e.g., a minimum debt yield or debt service coverage), thereby providing another measure of protection. Adding shorter duration loans to a debt portfolio allows investors to minimize their exposure to a hazier future, as compared to the typical 7- to 10-year term debt on stabilized assets. Finally, since these loans are most often based on a floating rate (i.e., LIBOR) with a floor, moderately rising interest rates should increase returns (to a point).

At this later stage in the cycle, investors are well-served to manage the impact of duration across their entire real estate credit portfolio.

2. What Big Button?

To the surprise of many, global institutional real estate investors have shrugged off the Twitter barbs between U.S. and North Korean leaders and continued to invest in the South Korean market. In fact, Seoul again ranked eighth among the most active commercial real estate markets globally in 2017 with approximately $14 billion in transaction volume.[3] It is estimated that over 20% of these transactions involved foreign investors, among them JP Morgan, Morgan Stanley, PGIM and Standard Chartered Bank.[4]

South Korea has a lot going for it, including one of the fastest growing economies among developed countries – nominal GDP CAGR of 6.43% (1995-2017) – and the highest sovereign credit rating among northeast Asian countries (AA/Aa2).[5] The South Korea stock market has remained resilient in the past year, with the KOSPI rising 21.8% in 2017. Seoul, the capital and economic center of South Korea, is the world's fourth largest metropolitan economy and the second largest office market in Asia.[6] The Seoul office

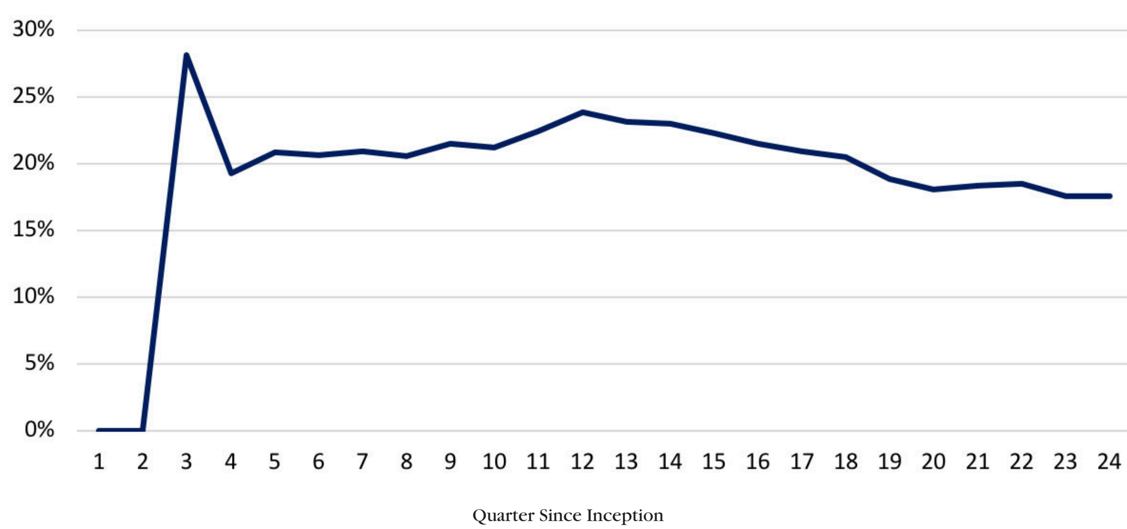
[1] Preqin Data
[2] Preqin Data
[3] JLL Global Capital Markets Research Q4 2017
[4] IGIS Research, January 2018
[5] Bank of Korea Statistics
[6] International Monetary Fund, World Economic Outlook, April 2017. Savills Korea Research, January 2018

market historically has been among the most established in major Asian cities offering both ample availability of office stock and liquidity through a deep domestic institutional investment market. Moreover, there continues to be a healthy positive spread of over 200 bps between domestic treasuries and core yields.[7] We anticipate that the Seoul office market will continue to see strong transaction activity in 2018 in spite of geopolitical concerns given its relative attractiveness amongst its Asian peers. The Winter Olympics that recently took place in PyeongChang helped to diffuse North-South tensions and is likely to give the market additional impetus by showcasing Seoul, and South Korea in general.

3. Valuation Is in the Eye of the [Share]holder

The substantial majority of real estate fund managers have been in existence for 10+ years, managing multiple funds/vehicles over the course of at least one cycle. As such, the benchmarking of historical investment performance is an increasingly important factor, if not the most important factor, when institutions and consultants are considering allocating capital to managers. The challenge is that managers employ very different approaches to estimating "fair values" for their unrealized investments. Under U.S. GAAP (ASC Topic 820), "fair value" is defined as the "price that would be received to sell an asset… in an orderly transaction between market participants…" Certain publicly listed investment managers, by way of example, more rigorously mark assets to "fair value" on a quarterly basis for closed end funds (thereby accelerating the recognition of gains), as compared to many private fund managers that often take a more conservative approach. Seven of the top 10 publicly-listed fund managers report investment returns in their public disclosures.[8] We identified seven funds representing over $35 billion of AUM that reported double digit net annualized returns in the first 24 months (with a weighted average return of 21%).[9] This is in contrast, in our experience, to boutique managers that typically take a more conservative approach to valuations, often holding investments at cost for up to several years. Why the discrepancy? Perhaps because the shares of public managers are valued in part on a measure of quarterly earnings per share referred to as "Economic Net Income" or "ENI", which includes the accrual of incentive fees.

Average Net Annualized Returns Since Inception[10]



[7] IGIS Research, January 2018
[8] Preqin Data; top 10 based on capital raised over the last 10 years
[9] Based on historical public filings of several publicly traded fund-managers
[10] Index calculated by Hodes Weill and weighted based on AUM. Based on annualized returns since inception for seven funds sponsored by public managers.

As a result of this range of valuation methodologies, the benchmarking of recent vintage funds can be challenging (and the results misleading). Further, this issue may be exacerbated by the fact that public managers tend to manage large cap funds, which has the effect of disproportionally skewing relative performance metrics, including quartile rankings. In order to identify the best performers, our industry is going to have to look deeper into the numbers to more accurately assess performance.

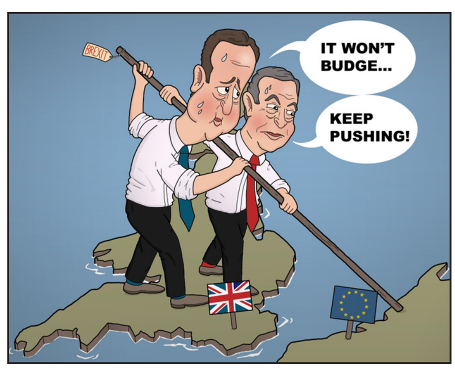
4. India 2.0

Institutional investor interest in India appears to be on the uptick once again, following a long hiatus that largely resulted from the poor performance of the 2005-2008 vintage funds. Although India is far from becoming a mainstream allocation in Asian portfolios, the country has clearly come back into focus for many global investors who recognize that they cannot afford to ignore India. Over the next decade, India will become the world's third-largest economy; possess one of the top–five equity markets; and will be one of the key global consumer and e-commerce markets.[11] A reform-minded and stable government has achieved average GDP growth of 7.5% for the last three years[12] and implemented major policy reforms, such as demonetization, a unified Goods & Services Tax, and the new Real Estate (Regulation and Development) Act ("RERA"), which should bring more transparency and discipline to the development market. An ambitious biometric identification system has already registered 1.2 billion people out of a population of 1.3 billion, hopefully leading to greater participation in the economy.[13]

These developments have not yet resulted in a widespread return of LP appetite for India-focused funds, but we think this could well be changing. In the past year, institutional joint ventures have been formed targeting lending logistics, office, affordable housing, middle-income residential and retail. An emerging domestic REIT market could also provide greater institutional liquidity. It is evident that larger institutional investors are beginning to plant flags in recognition of the country's long-term prospects, and more investors are likely to follow over time. We are now seeing a handful of high quality institutional fund managers venturing back out on the fundraising trail, with the aim of once again attracting interest from global LPs for more conventional commingled offerings. We expect India fundraising activity to grow in the coming years, albeit with offerings that include much narrower investment strategies, stricter governance and greater investment controls than we saw in the prior cycle.

5. London – A Place to Invest?

If, on June 24, 2016, Brexit plus one day, we were told that the London real estate market would top the global "most invested" list for 2017, we would have been mighty skeptical. Yet, as recently reported by JLL, this was the case. We see a number of reasons why investors have continued their love affair with London despite BREXIT risks. It remains the deepest and most transparent market in Europe with a multi-cultural population that voted to stay in the E.U. London is not just a financial market but has a diversified economy with a strong technology element. Asian investors (many of whom spent time in the U.K. getting their education) now see it as a long-term safe haven, and BREXIT is just



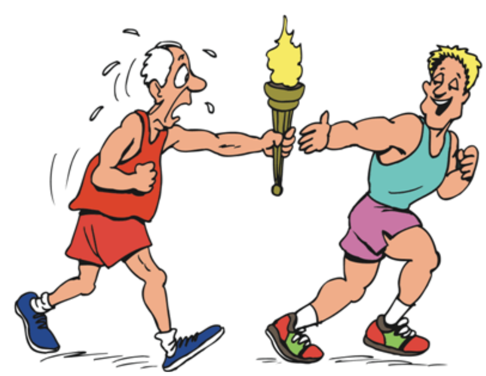
[11] Gettleman, Jeffery. "India's Economic Woes Are Piercing Modi's Aura of Invulnerability." New York Times. January 6, 2018
[12] Oxford Economics, 2017
[13] Bengali, Shashank. "India is building a biometric database for 1.3 billion people — and enrollment is mandatory." Los Angeles Times. May 11, 2017

another "speed bump" in a world full of geopolitical risks. Conversely, we are also seeing investors, many of whom are benefitting from the weakness of the pound, backing managers who can pursue specific value-add strategies to "buy, fix and sell' well-located City fringe assets. Many assets are poised to benefit from the imminent arrival of CrossRail (Elizabeth Line) in late 2018 which will open up much easier access East-West and to Heathrow airport. We won't be surprised if London remains at or close to the top of the most invested list again this year.

6. Invest in Retail? In Europe? Really?

For the past five years, the real estate industry has debated the plight of retail, and especially shopping centers globally. After the consolidation of ownership of the "fortress malls" in U.S. and, more recently, in Europe (seen recently through the merger of Unibail/Westfield and Hammerson/INTU REITs in Europe), where is the opportunity left in retail? Retail may already be oversold, especially in certain specialty areas. In the U.S., an opportunity still lies in urban "walkable" retail serving more affluent residents in attractive metro areas. In Europe, especially on the Continent where zoning is much tighter for shopping centers than in the U.S. and U.K., retail centers remain the focal point of many towns and cities. Many remain under-managed and under-invested. We acknowledge that retail is a specialist strategy in a rapidly changing environment (in a generally challenged sector). Hence, it takes real conviction to pursue the sector and real expertise to maximize returns. Further, we believe that in certain continental European markets, the retail sector will be resolute against, and even benefit from, the increasing influence of online shopping, which has created the need for omni-channel retailing and in-store collection. While certainly a contrarian play, we expect to see growing support from investors who can slice through the barrage of headlines, and managers with consistent track records in the sector should be the beneficiaries.

7. I'll Have the Stake



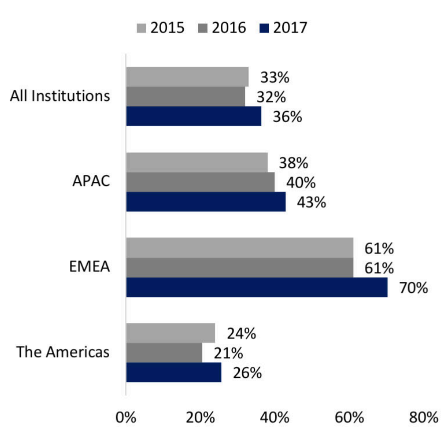
2017's uptick in the sales of fund managers, both outright and through minority, non-governing positions (aka "stakes"), has industry participants taking note. Are we witnessing an acceleration in a consolidation trend in the real estate private equity industry which counts over 3,000 managers globally? If so, what is driving previously independent managers to sell? Frankly, scale increasingly matters to global investors. The headwinds facing small to mid-size fund managers in the post-GFC fundraising environment have been well documented. Between 2011 and 2017, the top 10 largest fund managers have accounted for 25% of investor commitments raised for closed-end private real estate funds.[14] Smaller, boutique managers have had to spend a disproportionate amount of time and energy on the road capital raising. This increasingly arduous fundraising cycle is also taking its toll, requiring too much of the owners' time away from the business and time spent away from investing. Smaller funds and thinner margins are also impacting liquidity, especially capital for the GP's co-investment. Perhaps it's no surprise that a growing number of managers see the benefit of aligning with larger platforms boasting strong distribution capabilities, a more established brand name, and/or greater economies of scale. An additional catalyst is access to growth capital to fund an expansion into adjacent strategies or new geographies. Finally, succession planning remains a challenge for our industry, as many founders look to pass on ownership in their businesses to the next generation of partners. A stake sale can provide the resources needed to facilitate such plans. When we match these considerations with the white-hot demand from global asset managers to grow their own platforms and income streams, we believe we have a recipe for further consolidation in the years to come.

8. Take the ESG Train

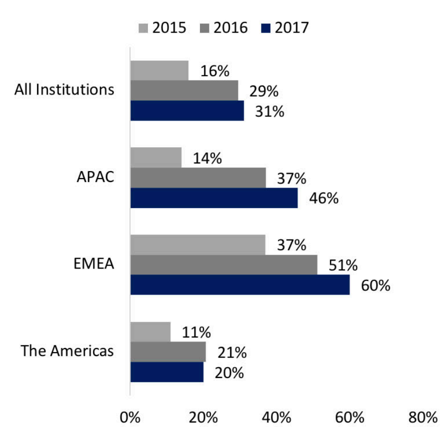
An increasing number of investors are directing real estate capital towards managers that are proactively measuring and managing environmental, social and governance (ESG) factors in their investment decisions. Callan Associates conducted its fifth Annual ESG Survey of U.S. investors and found that 37% of survey respondents reported that they incorporated ESG factors into their investment process, up from 22% in 2013.[15] The 2017 Institutional Real Estate Allocations Monitor that Hodes Weill conducts with the Cornell Baker Program in Real Estate found similar results, with 31% of institutions incorporating ESG factors into their investment processes, up from 16% in 2015.[16] Larger investors, with assets in excess of $20 billion, have been the highest adopters of ESG investing. Callan reported that 78% of the largest plans incorporated ESG in 2017 versus 33% in 2013. EMEA is significantly ahead of the other regions with 70% of institutions adopting ESG policies according to the 2017 Allocations Monitor, but other regions are rapidly catching up. GRESB, an organization that now includes 61 investor members, is playing a leading role in accelerating industry adoption of the environmental aspects of ESG best practices by providing adoptable frameworks and metrics to assess real estate performance in comparison to other real estate managers.

What does this all mean? This trend is picking up momentum, driven not only by capital sources but tenants as well, so managers who want to be considered best in class, both as operators and fiduciaries, are wise to heed the call.

Formal ESG Policies: All Institutions and by Location of Institution[16]



Investment Process Influenced by ESG Policies: All Institutions and by Location of Institution[16]



[14] Preqin Data
[15] Callan surveyed 105 asset owners, representing more than $1.1 trillion in assets this past August
[16] Jones, D., & Weill, D. (2017). 2017 Institutional Real Estate Allocations Monitor. Ithaca, NY: Cornell University's Baker Program in Real Estate and Hodes Weill & Associates, LP, October 2017. 22pp.

9. The New American Dream?

"Property ownership is *so* nineties! Gerald and I sold our house to a private consortia and are leasing back."

Despite an uptick in homeownership rates driven by young buyers, the recent tax bill may take some momentum out of the housing market in the U.S. As if there already weren't reasons to rent (large student loans, transient nature of jobs, preference of cities to suburbs, etc.), the limit on deductibility of property taxes and the lower limit on mortgage interest deduction make home ownership less affordable. For real estate investors, we think this could create an opportunity in rental properties, especially those in high cost states like New York and California. We expect an increase in multifamily occupancies, but this may also drive people to rent single family homes (why go and buy a home in a great school district that likely has high property taxes when you can rent?). Regardless of renting versus buying, we expect cities to be the large beneficiaries of these trends, followed by commuter towns proximate to these cities. It will also be interesting to monitor the changing role of Fannie Mae and Freddie Mac if fewer people are buying homes (and if there is less of an incentive to buy homes that may otherwise be unattainable without levering up). A larger question may be: if people are putting less capital into housing (home ownership, renovations, etc.), will this free up more capital for discretionary spending and will retail, not rental housing, be the true real estate beneficiary of the changing tax code?

10. Necessity is the Mother of Reinvention

Lack of quality deal flow and challenges in accessing niche strategies have forced both GPs and LPs to become more creative when it comes to structuring partnerships. Taking a stake (be it majority or minority) at the operating company level, allowing for participation in management fees and access to co-investments; participating in a "GP fund", in which the LP invests alongside a larger vehicle at preferred economics; and buying into an existing portfolio of assets, providing visibility and mitigating any J-curve effects, are just a few of the ways investors have shown, and will continue to show, innovative thinking. And this is especially true when it comes to harder-to-access niche strategies, with manufactured housing, senior living, skilled nursing, life sciences and medical office as just a few examples. Factor in the benefits to GPs in these situations, which can include shorter capital-raising time horizons relative to commingled vehicles and a viable path for more nascent groups, and we anticipate an increasing volume of creative new vehicles in the coming years. "Throwing out the old playbook" and considering non-traditional structures, while bringing to the fore new risks and considerations, will become more common going forward, addressing concerns over access to quality deal flow and helping to shape the ever-evolving fundraising market.

The Road Ahead

And so, as 2017 recedes further into the background, we focus on the year ahead. We remain excited about the prospects for the future, and energized by the expanding array of opportunities in the real estate private equity sector. Despite risks and challenges, investors and fund managers demonstrate daily their commitment to building out their real estate portfolios. It is hard work but we are confident that our industry is well up to the task of underwriting attractive investment opportunities and sectors that are responsive to an evolving and increasingly complex world.

We will share observations about the impact of new technologies in an upcoming market commentary – with so much to say, it deserves its own paper. That said, disruption and innovation in our industry were not brought about by technology alone, but perhaps more so by the global financial crisis and its aftermath. As in the past, when the industry emerged from prior down cycles, the GFC forced us all to re-think our basic approaches, investment vehicles, asset classes and the relationships among the stakeholders in the industry. Perhaps the extraordinary levels of global liquidity have, indeed, reduced yields and dampened return expectations on a more secular basis. Regardless, the global search for yield makes it imperative that capital be deployed in our asset class. Putting all the geo-politics, disruption and transformation aside, finding creative solutions that address investor needs, that allows investors to deploy their capital consistent with their risk tolerance, and that fairly compensates managers for their hard work, remains the order of the day.

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